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NOT TO BE PUBLISHED

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

(Sacramento)

EDUCATIONAL EMPLOYEES CREDIT UNION et al., Plaintiffs and Appellants, v. FRANCHISE TAX BOARD, Defendant and Appellant.	C020733 (Super. Ct. No. CV511821)

This is a tax case involving the treatment of income earned and expenses incurred by state-chartered credit unions. The plaintiff taxpayers[1] (Taxpayers) seeking refunds from defendant Franchise Tax Board (Board) are six such credit unions that, unlike their federal counterparts, are subject to taxation by the State of California. However, most of their income is

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[1] The plaintiffs are six state-chartered credit unions, as follows: (1) Educational Employees Credit Union, (2) The Golden One Credit Union (Golden One), (3) San Francisco Firemen Credit Union, (4) Northrop Employees Federal Credit Union, (5) Schools Federal Credit Union, and (6) City and County Employees' Credit Union of Alameda County.

derived from interest on loans to members that is exempt from taxation. (Rev. & Tax. Code, § 24405.)[2] Until 1999 investments with nonmembers, unlike loans to members, could generate taxable income.[3] With respect to such income, Taxpayers sought to deduct various sums, including a portion of dividends paid to members on share deposits and a percentage of operating costs. Following a court trial lasting 55 court days, the trial court rejected Taxpayers' various theories supporting the deductibility of share dividends and disapproved Taxpayers' formula for allocating a portion of operating expenses to investment income. Taxpayers appeal, asserting the court erred in determining that share dividends are not deductible as either interest, patronage dividends, or business expenses; in finding that investment income is not deductible as business done with members; and in rejecting their method for allocating expenses between taxable and tax-exempt income. In its cross-appeal, the

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[2] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated. References to codes generally are to sections in effect during the years at issue, 1979-1985, and our commentary on the law, though framed in the present tense, refers to statutory law in effect when Taxpayers earned the income that is the subject of the current dispute.

[3] The Legislature in 1987 amended section 24405 to significantly reduce the exposure of credit union investment income to taxation (Stats. 1987, ch. 1465, § 1; § 24405, subd. (c)) and in 1999 exempted state-chartered credit unions from income taxes entirely (Stats. 1999, ch. 675, § 1; § 23701y). The present appeal involves issues arising under prior law, and thus, while some of the issues raised herein are issues of first impression, they are not likely to recur in light of the legislative changes.

Board claims the trial court erred in excluding consideration of Taxpayers' liability for taxes on income received from investments in corporate credit unions. We affirm.

INTRODUCTION

Credit Union Characteristics

Credit unions are nonprofit corporations formed and operated for the purpose of pooling members' savings to provide a source of credit and other financial services. Credit union members deposit dollars in accounts known as share accounts. All credit union members are depositors and thus are savers. Credit union members have the right on notice to withdraw deposits from their share accounts. (Fin. Code, § 14867.) Credit union members who deposit funds in a share account generally receive a return on those funds if the credit union is profitable. The return is called a share dividend. Some credit union members, in addition to saving, also borrow from the credit union.

Though credit unions perform many of the same financial functions as for-profit banks and savings associations, they differ in management and purpose. They are controlled by the members through elected governing boards and exist solely for their members' benefit. Each member has one vote, regardless of the number of dollars maintained in that member's share account. (Fin. Code, § 14806.) A share account co-owner who is not a member of the credit union has no vote by reason of the account ownership. (Fin. Code, § 14851, subd. (b).) By law, members of a credit union can grant proxies. (Fin. Code, § 14820.)

Credit unions emphasize member services, the philosophy that members are owners, and the pooling of resources to provide credit to members. Interest on loans is lower than rates at commercial institutions. Share dividends vary in relationship to the services offered and the interest charged on member loans, but credit union dividend rates are higher than interest rates on savings paid by commercial institutions.[4] If declared by the board of directors, dividends are distributed to members from undivided profits. Though the board of directors may establish the rate of dividends in advance, dividends can be paid only if there are profits. (Fin. Code, §§ 14901-14902.)

Credit Union Dividends and Income

Credit union profits are derived from loans and third party investments. Loans and investments are made from funds deposited by credit union members in their share accounts.

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[4] The trial court found that credit union income is suppressed by below-market loan rates, above-market dividends, and the provision of other financial services at low or no cost: "The court finds that plaintiffs' net income remaining after the payment of dividends is not comparable to the net taxable income of non-cooperative for profit financial institutions such as banks and savings and loans. This lack of comparability arises from the payment by credit unions of higher dividend rates to members than the interest rates paid to depositors at the for profit institutions, coupled with the issuance of loans at more favorable rates to members by the credit unions than the for profit institutions offer to borrowers, along with the provision by credit unions of low or no cost services to members. Together these items produce an artificially low net income after dividends for the credit unions which is not comparable to the net taxable income of for profit financial institutions such as banks and savings and loans."

Income that arises from business activities conducted for or with members is deductible under section 24405. Under section 24405, the lion's share of credit union income -- interest earned on loans made to members -- is not taxable. Historically, income earned on investments made with third parties has been taxable. Generally, the taxable investments were large, few in number, and inactive, except for receipt of income.

Taxpayers claim that third party investment income constitutes income arising from business activities for the benefit of members and thus is exempt from taxation under section 24405. If Taxpayers prevail on this claim, credit unions would have been largely exempt from the payment of income taxes, thereby rendering moot the remaining issues raised in this appeal. If, on the other hand, third party investment income is taxable, then Taxpayers argue they are entitled to deduct from that income some portion of shareholder dividends either as interest or as patronage dividends. Taxpayers proposed an asset-based allocation formula to determine the portion of shareholder dividends that would be deductible in light of section 24425, discussed *post*. The trial court affirmed that third party investment income is taxable and rejected Taxpayers' various theories supporting the deductibility of share dividends in whole or part. Taxpayers disagree with the trial court's conclusions.

Credit Union Expenses

Taxpayers incur operating expenses in maintaining members' share accounts and otherwise conducting credit union business. Expenses are incurred in creating and maintaining members' share accounts and in making and maintaining loans and investments. The typical operating expenses incurred in the share account deposit function include the cost of receiving the funds, accounting for deposits, keeping track of deposits, and providing for share withdrawals. Expenses incurred in the loan function typically are costs of interviewing, accepting or rejecting loan applications, keeping track of loan balances, collecting interest payments, and delinquency costs for bad loans. These expenses would qualify for deduction as ordinary and necessary business expenses under the Revenue and Taxation Code (Rev. & Tax. Code, § 17201, subd. (a); 26 U.S.C. § 162), except for the provisions of Revenue and Taxation Code section 24425, which state that expenses incurred in the production of nontaxable income cannot be claimed as a deduction from taxable income.[5]

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[5] At all pertinent times, section 24425 provided that no deduction would be allowed for "[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part . . . ." As earlier noted, section 24405 exempts income from "activities for or with members." As applied, section 24405 exempted income derived from credit union member loans.

Under section 24425, only operating expenses incurred in the production of taxable income are deductible. Taxpayers did not maintain records that would permit expenses to be categorized by the nature of the income attributable to the expense incurred. Instead, Taxpayers developed a formula for allocating credit union operating expenses between taxable and nontaxable income premised on the assumption that equal effort is required to produce a dollar of loan income as to produce a dollar of deposits and that deposits support both loans and investments. The trial court determined that substantially all of Taxpayers' operating expenses would have been incurred regardless of whether any investment activity had taken place. Such expenses relate to investment income only in the sense that they relate to funds that might end up in investments. Inasmuch as Taxpayers could not establish the expenses were necessary for the production of taxable income, the trial court rejected Taxpayers' allocation formula and denied a deduction for claimed operating expenses. Taxpayers assert that in so doing the trial court erred.

The Cross-Appeal

The Board agrees with the trial court that income received by Taxpayers from third party investments generally is not exempt from taxation, but asserts in its cross-appeal that the court erred in refusing to consider the question of whether Taxpayers are also obligated to pay taxes on income from investments in corporate credit unions.

The Standard of Review

The record in this case rests on stipulated facts supplemented by oral testimony and documentary evidence.[6] Many facts are undisputed. On those matters where the decisive facts are undisputed we are confronted by questions of law, and we are not bound by the trial court's findings. Where facts are disputed and the trial court made factual findings, we review those findings under the substantial evidence standard. (*Tenneco West, Inc. v. Franchise Tax Bd.* (1991) 234 Cal.App.3d 1510, 1520-1521.) The proper interpretation and application of tax statutes presents a question of law that we examine de novo. (*Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.* (1991) 229 Cal.App.3d 784, 794 (*Rain Bird*).)

In a suit for a tax refund, the taxpayer bears the burden of affirmatively proving its right to a refund of the taxes by a preponderance of the evidence. (*Consolidated Accessories Corp. v. Franchise Tax Board* (1984) 161 Cal.App.3d 1036, 1039.) The Board's determinations are presumptively correct and the taxpayer bears the burden of proving them incorrect. (*Hall v. Franchise Tax Board* (1966) 244 Cal.App.2d 843, 848; *Sunshine Art Studios of California, Inc. v. State Bd. of Equalization* (1974) 39 Cal.App.3d 223, 231 (*Sunshine Art*).) "Deductions may be

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[6] The parties have filed multiple requests for judicial notice. We previously granted the Board's request filed on July 30, 1996. Taxpayers' request filed on November 20, 1996, and the Board's requests filed on December 27, 1996; January 31, 1997; and February 26, 1997, are granted.

allowed or withheld by the Legislature as it sees fit [citations] and such deductions, like credits and exemptions, are to be narrowly construed against the taxpayer [citations]." (*Great Western Financial Corp. v. Franchise Tax Bd.* (1971) 4 Cal.3d 1, 5 (*Great Western Financial*).)

With these general principles in mind we first consider, and reject, the Board's assertion that evidence of Taxpayers' investment operations, except for evidence offered by Golden One, should have been excluded based on the failure to exhaust administrative remedies. We next take up Taxpayers' arguments that investment income is exempt from taxation and that shareholder dividends are deductible, in some fashion, from taxable income. Next we consider Taxpayers' claim that the trial court erred in rejecting their formula for allocating operating expenses between taxable and nontaxable income. We also consider Taxpayers' claims concerning the validity of Audit Ruling 111.1 and the fairness of the Board's procedures. Finally, we resolve the issue raised by the Board's cross-appeal, the taxability of income from corporate credit unions.

I

The Board, apparently reversing the position its employees took during the administrative proceedings, contends Taxpayers, with the exception of Golden One, failed to exhaust their administrative remedies. The Board contends that, with the exception of Golden One, the trial court erred in admitting evidence offered by Taxpayers because they did not produce factual evidence to support the application of the allocation

formulas. (*Barnes v. State Bd. of Equalization* (1981) 118 Cal.App.3d 994, 1002.) The argument is odd on several grounds.

First, Thomas Rodrique, the manager of the Board's audit protest unit, testified that he assured Taxpayers they had exhausted their administrative remedies. Moreover, during the protest proceedings, Taxpayers asked the Board's representatives whether they understood each ground raised in the supplemental protests and claims for refunds, and whether they had enough factual support for each issue. The Board's representatives gave an unqualified "yes" in response. We agree with Taxpayers that the exhaustion doctrine is not properly used to exclude evidence the Board did not request or know it needed. Moreover, the parties had agreed to use Golden One as a test case to determine the issues of law common to other credit unions.

Second, the Board would have us turn the exhaustion doctrine on its head. Taxpayers effectively rebut such a novel application of the exhaustion doctrine: "The exhaustion of administrative remedies doctrine is not an evidentiary preclusion doctrine but a jurisdictional doctrine designed to relieve the burden of overworked courts. All that is required for exhaustion purposes is that a taxpayer apprise the Franchise Tax Board in writing of the grounds of its claim for refund and cooperate with the agency in the course of the protest. Apprisal is the standard. (See *Wallace Berrie & Co., Inc.* v. *State Bd. of Equal.* (1985) 40 Cal.3d 60, 66, n. 2 [219 Cal.Rptr. 142, 707 P.2d 204]; *Barclays Bank Internat. Ltd.* v. *Franchise*

Tax Bd. (1992) 10 Cal.App.4th 1742, 1749-1750 [14 Cal.Rptr.2d 537] affd. (1994) 512 U.S. ___ [129 L.Ed.2d 244, 114 S.Ct. 2268]; *Delta Air Lines, Inc.* v. *State Bd. of Equal.* (1989) 214 Cal.App.3d 518, 528-529 [262 Cal.Rptr. 803].) [The Board] makes no claim, and indeed there could be none, that [Taxpayers] did not apprise the Franchise Tax Board of the bases of their claims for refund. (Section 19322 (formerly Section 26080.1).) Nor is there any assertion that the case below was brought on anything other than the grounds set forth in the claims. (Section 19347 (formerly Section 26080).) There is uncontroverted evidence that [Taxpayers] informed [the Board] of the grounds upon which they were proceeding. [Citations.] It is also uncontroverted that [the Board's] tax counsel and hearing officers were apprised of the grounds of [Taxpayers'] claims and understood them. [Citations.]" [Fns. omitted.] We agree.

The trial court ruled that Taxpayers exhausted their administrative remedy. The record and the law fully support that ruling.

II

A. Exemption of Investment Income Under Section 24405

Taxpayers argue that any income they earned from third party investments is exempt from taxation under former section 24405 as income from business done for members. Subdivision (a) of section 24405 provided in pertinent part: "In the case of other associations organized and operated in

whole or in part on a co-operative or a mutual basis, all income resulting from or arising out of business activities for or with their members carried on by them or their agents, or when done on a nonprofit basis for or with nonmembers . . . ."[7]

Whether investments in United States government securities constitute "business activities for or with" credit union members was considered in *Long Beach Firemen's Credit Union v. Franchise Tax Bd.* (1982) 128 Cal.App.3d 50 (*Long Beach Firemen's*). The credit union invested in the International Credit Union (ICU) Government Securities Program operated by an

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[7] In 1987 the Legislature amended Revenue and Taxation Code section 24405 to add subdivision (c), which provides that income from a credit union's investment of surplus member savings in specified investments is deductible under subdivision (a). A 1993 amendment placed income from reciprocal transactions with member credit unions within the ambit of the subdivision. (§ 24405, subd. (d).) As amended, section 24405, subdivision (c) reads as follows: "For the purposes of subdivision (a), a credit union's activities are 'for or with' the members of the credit union if the activities involve the investment of surplus member savings capital in investments permitted for credit unions pursuant to Sections 14406 [deposits in commercial banks, deposits and certificates in savings and loans and credit unions], 14652 [legal investments for savings banks], 14653 [credit union government securities investment trust], 14653.5 [as authorized by the commissioner of corporations], 14654 [conditional sales contracts, lease agreements], 14655 [promissory notes], and 14656 [notes of liquidating credit union] of the Financial Code. 'Surplus member savings capital' means the savings capital of credit union members which is in excess of the amount of savings capital which is loaned to members of the credit union. The term 'savings capital' shall have the meaning set forth in subdivision (a) of Section 14400 of the Financial Code." Financial Code section 14400 provided: "The savings capital of a credit union shall consist of the payments made by members on shares."

association established to provide financial services to credit unions. The credit union solicited ICU's membership and ICU obliged. ICU's status as a credit union member permitted the credit union to argue that its investments with ICU constituted business activity "with" a credit union member, thereby rendering any income therefrom deductible under section 24405. (*Long Beach Firemen's, supra*, 128 Cal.App.3d at p. 53.) The Court of Appeal was not persuaded, concluding that "the investment of surplus funds in government securities, whether or not through the conduit of the credit union membership, is not a covered transaction within the meaning of [the] section." (*Id.* at p. 54.) According to Taxpayers, the *Long Beach Firemen's* holding has no application to the present case; the court in *Long Beach Firemen's* construed what it means to engage in business activity "with" a credit union member while the present case concerns business activity "for" credit union members. Taxpayers argue third party investment returns increase the pool of profits that can be distributed to member shareholders; consequently, the investment activities and resulting income are "for" the members and fall within the ambit of section 24405.

We agree with the Board that such an expansive reading of the statute obliterates all lines between deductible and taxable income from third party sources. Presumably, all income from credit union business activities inures to the benefit of shareholders by increasing the pool of funds from which dividends are paid. Taxpayers' reading of the statute provides no meaningful distinction between income from activities with

third parties and earnings from loans to credit union members -- the principal source of credit union income. Clearly, section 24405 was not intended to embrace all business activities that *benefit* credit union members. As we declared in *Woodland Production Credit Assn. v. Franchise Tax Board* (1964) 225 Cal.App.2d 293 (*Woodland Production Credit*), the phrase "business activities," as used in that section, "applies only to the cooperative's transactions with or as agent for its patrons. These transactions, and these alone, are 'business activities' which yield income deductible under [the statute]." (*Id.* at pp. 299-300, fn. omitted.)

It is true that the credit union in *Long Beach Firemen's* claimed it engaged in business "with" a credit union member. However, notwithstanding ICU's membership status, the court broadly held that the activity was "not a covered transaction within the meaning of [the] section." The court's holding reflects a general antipathy towards expansive constructions of section 24405 to embrace all profitable activities that inure to the benefit of members.

As the court opined: "In determining that the investment transaction in question is not a covered business activity, we are mindful of the following rule: 'Deductions may be allowed or withheld by the Legislature as it sees fit [citations] and such deductions, like credits and exemptions, are to be narrowly construed against the taxpayer.' (*Great Western Financial*[, *supra*,] 4 Cal.3d [at p.] 5 [92 Cal.Rptr. 489, 479 P.2d 993].) Further, the burden of proof was on the taxpayer to show that

the tax assessment was in error and that money paid should have been refunded. (*Sunshine Art*[, *supra*] 39 Cal.App.3d [at p.] 231 [114 Cal.Rptr. 24].) The record does not demonstrate that the court erred in concluding that plaintiff did not meet its burden here." (*Long Beach Firemen's*, *supra*, 128 Cal.App.3d at p. 55.) Similarly, we conclude the record in the present case does not demonstrate error.

B. Deductibility of Shareholder Dividends as Patronage Dividends

Both federal and California law provide favorable tax treatment for cooperatives -- business entities organized to provide supplies to their members (also called "patrons") or to market the patrons' products.[8] The theory is that cooperatives are merely acting on behalf of their patrons. Profits from transactions in member products are returned to the members based on their patronage of the cooperative. The cooperative is merely turning over earnings that were collected by the cooperative but properly belong to the patron. Because the cooperative merely serves as a conduit, it is not taxed on such profits. These distributions qualify as patronage dividends under subchapter T of the Internal Revenue Code. (26 U.S.C. § 1388.) Taxpayers argue that money is like any other commodity

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[8] Although formal membership is not required. A patron may be any person with whom or for whom a cooperative organization does business on a cooperative basis. (9 Mertens, Law of Federal Income Taxation, § 34A:01, Westlaw, MERTENS § 34A:01 [as of December 2005].)

and a credit union is a cooperative that offers its members' money for sale. Share dividends are a form of patronage paid on profits from the sale of money and qualify for the deduction provided under California tax laws for patronage dividends. Taxpayers' analogy is enticing, but we are not persuaded.

The only explicit statutory authority for deducting patronage dividends is section 24406, which, by its terms, does not apply to credit unions. Taxpayers deny there is a need for explicit statutory authority, reasoning "Patronage is not profits or income but savings produced for patrons through a pooled effort." In other words, patronage dividends are not income at all. Interestingly, Taxpayers cite in support of their position the case of *California State Auto. Assn. v. Franchise Tax Bd.* (1987) 191 Cal.App.3d 1253 (*CSAA*), a case dealing with the proper construction of section 24405, which, as we discuss above, provides a deduction to "associations organized and operated in whole or in part on a co-operative or a mutual basis" for income arising from "business activities for or with" their members. In the cited case, the issue was whether the California State Automobile Association qualified as an association operated on a cooperative or mutual basis. The court noted "the underlying theory behind the excludibility of income under section 24405 . . . is that such earnings are not 'profits' but rather savings produced for patrons through a pooled effort." (*CSAA, supra*, 191 Cal.App.3d at p. 1260.)

The same theory underlies federal treatment of patronage dividends. As expressed by the United States Court of Federal

Claims, the federal deduction for patronage dividends "has not been placed upon the ground that cooperatives are special creatures of statute under the tax laws, but is justified rather upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales . . . and thus do not constitute taxable income to the cooperative. [Citation.] '"The theory is that the cooperative is merely a conduit . . . ."' or a trustee for the dividends, which '"are at all times the property of the member stockholders."' [Citations.] The money involved never belongs to the cooperative." (*Columbus Fruit and Vegetable Co-op. Ass'n, Inc. v. U.S.* (1985) 7 Cl.Ct. 561, 563-564.) The court's comments related to title 26 United States Code section 1388, which provides, in pertinent part: "(a) Patronage dividend.-- For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies-- [¶] (1) on the basis of quantity or value of business *done with or for such patron*, [¶] (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and [¶] (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons." (Italics added.)

Thus, the deduction for patronage dividends under federal law, like the deduction provided by section 24405, requires a finding that the underlying business activity was done with or for a member of the association. We have earlier concluded the

activities here at issue were not "for or with" credit union members within the scope of section 24405. The resulting share dividends do not qualify as patronage dividends.

C. Deductibility of Shareholder Dividends as Interest

Interest is deductible under section 24344. Taxpayers' claim for a deduction of share dividends rests on two propositions related to the deductibility of interest. First, they assert that the Revenue and Taxation Code, not the Financial Code, controls the characterization of share dividends and the Legislature, in the Revenue and Taxation Code, treats credit union payments to members as interest. Second, Taxpayers insist that the character of share dividends must be examined under a traditional debt/equity analysis universally used in tax cases. Applying such an analysis, Taxpayers assert it is clear that a debtor/creditor relationship exists between credit union depositors and the credit union. Share dividends are payments on debt, otherwise defined as interest, and thus are deductible. The Board, on the other hand, argues the dividends label affixed to the payments by the Financial Code determines their deductibility.

Taxpayers' first proposition, pertaining to the proper characterization of share dividends, derives from former section 18803.[9] Section 18803, they argue, requires credit unions to report payments on withdrawable shares as interest,

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[9] Section 18803 was repealed in 1993. See now section 18639.

not dividends. This section stated, in pertinent part: "[An information] return may be required, regardless of amounts, in the case of [¶] (a) Payments of . . . amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect to deposits, investment certificates, or withdrawable or repurchasable shares . . . . [¶] (b) Dividends paid by corporations." By lumping payments made by credit unions with interest payments and placing corporate dividends in a separate category, the argument continues, the Legislature recognized share dividends as a form of interest for tax purposes.

We agree with the Board that Taxpayers read too much into the statute. Section 18803 did not prescribe how the payments were to be treated for tax purposes. Rather, section 18803 set forth a broad income surveillance mechanism. It imposed a reporting requirement applicable to credit union dividends as well as interest and other forms of dividends. If credit unions pay true dividends, they were to be reported under subdivision (b), but if the amount is interest or a payment by any other name, the payments were to be reported under subdivision (a). An information return provides the taxing authority with information on payments of every character made to taxpayers as a check on their obligation to self-report. The ultimate treatment of those payments is an entirely different issue unresolved by the reporting provisions of section 18803.

Taxpayers also rely on section 24580, which, before its repeal in 1991, authorized the Board to prescribe regulations to "set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. . . ." Like the Board, we dismiss the potential impact of section 24580 because no regulations were ever enacted. While the Legislature apparently saw a need for a delineation of the relevant factors, absent the implementation of the statutory directive, we are at a loss as to how to use the section. The best that can be said is that the Legislature recognized there would be a need to apply a debt/equity analysis at times, even though both interest and dividends are defined and described in various sections throughout the codes.

We also are not persuaded by the Board's definitional approach. During the years at issue, Revenue and Taxation Code section 24495 defined "dividend" as "any distribution of property made by a corporation to its shareholders-- [¶] (a) Out of its earnings and profits . . . ." Under section 14902 of the Financial Code, "[t]he directors of any credit union may, for the dividend period, declare dividends from its undivided profits," which are determined under Financial Code section 14903 by deducting from earnings the following: "(a) All expenses paid or incurred of whatever nature in the management of its affairs, the collection of its debts or the transaction of its business. [¶] (b) The interest

paid, or accrued and unpaid, on debts owing by it. [¶] (c) All provisions for losses sustained by it in excess of its regular reserve."

The Board concludes that the Legislature has thereby characterized the payments as dividends, not interest, because interest under subdivision (b) of Financial Code section 14903 is deducted from earnings before dividends can be determined.

There is no question that under these sections the payments are characterized as dividends. The issue, however, is not what the payments are called but whether they are deductible from gross income for tax purposes. While we find these sections descriptive, they are not dispositive of the relevant inquiry. If share dividends are not deductible, it is because of their essential attributes, their character as payments of equity ownership, not because of the name given them by an institution or the Legislature.

The trial court correctly discerned that these sections, coupled with Taxpayers' bylaws, "provide for the payment of dividends out of the net earnings credited to the surplus account after all expenses are paid." It does not follow, however, that payment of dividends from net earnings precludes deductibility as a matter of law. The resolution of that issue is legally and factually complicated. Clearly, though labeled dividends, payments to shareholders are similar to interest payments by banks and for-profit institutions and, as we discuss *post*, are treated as interest -- i.e., payment on debt -- for a variety of tax purposes. Nonetheless, as Taxpayers acknowledge,

share accounts also have many attributes of equity. They are more accurately regarded as hybrid instruments having both equity and debt characteristics.

Neither party has cited controlling statutory authority that neatly and simply resolves the dividend deductibility question as a matter of law. Nor has either party brought to our attention California case authority directly on point. In the absence of helpful state legal precedent, we turn to federal authority, which offers a measure of guidance but not a clear roadmap. As the United States Tax Court has declared, "*in seeking to determine whether a given relationship involves capital or debt or whether a given payment constitutes interest or a dividend, we enter a 'jungle' in which the decisional law 'continues to defy symmetry.'*" (*Joseph Lupowitz Sons, Inc. v. C.I.R.* (1972) 31 T.C.M. (CCH) 1169 (*Lupowitz Sons*), italics added, affd. in part and remanded, *Joseph Lupowitz Sons, Inc. v. C.I.R.* (3d Cir. 1974) 497 F.2d 862.)

Federal law, both statutory and decisional, describes a variety of factors to be considered in determining whether interest should be treated as stock or indebtedness. 26 United States Code section 385(b) suggests five factors: "1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, [¶] 2) whether there is subordination to or preference over any indebtedness of the corporation, [¶] 3) the ratio of debt to equity of the corporation, [¶]

4) whether there is convertibility into the stock of the corporation, and [¶] 5) the relationship between holdings of stock in the corporation and holdings of the interest in question." Many cases, however, use a longer laundry list, including "1) the names given to the certificates evidencing the indebtedness; 2) the presence or absence of a maturity date; 3) the source of the payments; 4) the right to enforce the payments of principal and interest; 5) participation in management; 6) a status equal to or inferior to that of regular corporate creditors; 7) the intent of the parties; 8) 'thin' or adequate capitalization; 9) identity of interest between creditor and stockholder; 10) payment of interest only out of 'dividend' money; and 11) the ability of the corporation to obtain loans from outside lending institutions." (*Anchor Nat. Life Ins. Co. v. C.I.R.* (1989) 93 T.C. 382, 400, fn. omitted.)

The weight allocated to a given factor depends on the financial transaction at issue. In *Paulsen v. Commissioner* (1985) 469 U.S. 131 [83 L.Ed.2d 540] (*Paulsen*), a state-chartered stock savings and loan association merged into a federally chartered mutual savings and loan association and the taxpayers' guaranty stock was exchanged for passbook savings accounts and certificates of deposit. The characterization of the instruments exchanged determined whether the merger constituted a tax-free reorganization.

Approaching this issue, the Supreme Court first described the equity characteristics of the savings accounts in the federally chartered mutual savings and loan association: "The

most important is the fact that they are the only ownership instrument of the association. Each share carries in addition to its deposit value a part ownership interest in the bricks and mortar, the goodwill, and all the other assets . . . . Another equity characteristic is the right to vote on matters for which the association's management must obtain shareholder approval. The shareholders also receive dividends rather than interest on their accounts; the dividends are paid out of net earnings, and the shareholders have no legal right to have a dividend declared or to have a fixed return on their investment. The shareholders further have a right to a pro rata distribution of any remaining assets after a solvent dissolution." (*Paulsen, supra*, 469 U.S. at p. 138.)

The Supreme Court minimized the equity characteristics, however, concluding they were "not as substantial as they appear on the surface." (*Paulsen, supra*, 469 U.S. at p. 138.) The right to vote, for example, was not very significant because, over a certain threshold, there was no correlation between the number of votes and the size of the investment, they were diluted by the votes accorded to borrowers, and most depositors usually signed proxies giving management their votes. The court also held that the payment of dividends was not controlling because, in order to remain competitive, the association paid fixed, preannounced rates on all accounts. Moreover, the right to participate in the net proceeds of a solvent liquidation was a remote contingency and therefore was a negligible factor in the shares' value. (*Id.* at pp. 138-139.)

In contrast, the court concluded that the substantial debt characteristics predominated. "Petitioners' passbook accounts and certificates of deposit are not subordinated to the claims of creditors, and their deposits are not considered permanent contributions to capital. Shareholders have a right on 30 days' notice to withdraw their deposits, which right [the association] is obligated to respect. While petitioners were unable to withdraw their funds for one year following the merger, this restriction can be viewed as akin to a delayed payment rather than a material alteration in the nature of the instruments received as payment. In this case petitioners were immediately able to borrow against their deposits at a more favorable rate than . . . depositors generally. As noted above, petitioners were also in effect guaranteed a fixed, preannounced rate of return on their deposits competitive with stock savings and loan associations and commercial banks." (*Paulsen, supra,* 469 U.S. at pp. 139-140.)

Taxpayers argue the logic of *Paulsen* applies to the present case and compels a conclusion that dividends constitute payment on a debt and thus are deductible as interest. Certainly there is an ample basis to so conclude. Because of the availability of credit union insurance, credit union deposits are largely risk-free. (Fin. Code, §§ 14858, 14867.) And members make withdrawals on demand. (Fin. Code, §§ 14807, 14867.) Share accounts are denominated in dollars, not in a number of shares. (Fin. Code, § 14865.) Each member receives only one vote, irrespective of the number of dollars invested, and they are not

transferable other than by proxy. (Fin. Code, §§ 14806, 14820.) Taxpayers were entitled to set dividend rates in advance and they always paid the preset rates and compounded the dividends as is usually done with interest. Like the passbook accounts and certificates of deposit in *Paulsen*, the share accounts are treated as cash equivalents to members and debt to Taxpayers.

Taxpayers' share accounts have other characteristics that resemble bank accounts much more than shares of stock. The passbook or other evidence of shares is not an "investment security" under the Commercial Code (Fin. Code, § 14866), nor is issuance of share accounts subject to the Corporate Securities Laws (Fin. Code, § 14850), and members receive no stock or share certificates. Share dividends must be treated as an expense, just like interest paid by a bank (Fin. Code, § 14901, subd. (b)), and share accounts are governed by rules similar to those governing bank deposits (see, e.g., Fin. Code, §§ 866-866.2; compare Fin. Code, §§ 850, 864 & former § 865 with Fin. Code, §§ 14853, 14856 & former § 15152). Share dividends, like interest, are compounded.

Nonetheless, we are not persuaded that the logic of *Paulsen*, as compelling as it might be in resolving tax issues arising from the exchange of stock in a state savings and loan association for a passbook savings account in a federally chartered mutual savings association, is as helpful in resolving the deductibility of credit union share dividends. The *Paulsen* court was not asked to decide whether payments on funds held in credit union share accounts should be treated as deductible

interest. This decisive question, in our view, must be answered in the negative.

Clearly, the relationship between credit unions and their share account holders has features of a debtor-creditor relationship. However, the dominant characteristics are those associated with ownership status. In their inception, credit unions were designed to provide credit to persons who could not qualify for assistance from for-profit financial institutions. The basic scheme was and remains a simple one, viz: individuals with a common bond of employment or profession band together to pool their savings and create a source of funds for loans and other financial services.[10] To facilitate their creation and growth, the federal government early provided favorable tax treatment for federally chartered credit unions, and California followed suit for state-chartered credit unions. Though credit unions have proliferated and many have grown to rival commercial institutions in the number and size of accounts, the basic scheme has not changed. Credit unions are still owned by the members. Earnings are distributed to members in the form of

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[10] "A credit union is a cooperative, organized for the purposes of promoting thrift and savings among its members, creating a source of credit for them at rates of interest set by the board of directors, and providing an opportunity for them to use and control their own money on a democratic basis in order to improve their economic and social conditions. As a cooperative, a credit union conducts its business for the mutual benefit and general welfare of its members with the earnings, savings, benefits, or services of the credit union being distributed to its members as patrons." (Fin. Code, § 14002.)

share dividends, lower loan rates, and services. (Fin. Code, § 14002.) Dividends, though declared in advance, can only be declared and paid from income. A credit union cannot pay a dividend if payment would result in a deficit in the credit union's undivided profits account. (Fin. Code, § 14902.) Insurance protects credit union members from the vicissitudes of financial markets, but ultimately the member-owners would stand behind other debtors in the event of a credit union failure. (Fin. Code, § 15255.) Members are an integral element of credit unions. Membership is not a mere formality. Only members can open share accounts. Unlike a bank customer, a member has a right to vote on the election of directors and on amendments to bylaws. Various statutory provisions provide rules prescribing who can become a member and cancellation of membership. (Fin. Code, § 14800 et seq.) These attributes of credit unions may be lost on credit union members who, like most stockholders, rarely exercise their powers of governance and regard their credit union as any other bank or savings and loan, but the important distinctions between banks and credit unions cannot be lost on us.

The statutes governing the relationship of credit unions to their members make it clear that members, who hold share accounts, are owners and not creditors. This is not to ignore the important differences between corporations and credit unions. Nor do we brush off the similar treatment accorded shareholder dividends and interest in calculating taxable income. However, tax laws, like the decisions construing them,

do indeed "defy symmetry." (*Lupowitz Sons, supra*, 31 T.C.M. 1169.) They reflect an assortment of policies, some connected with maximizing revenues, others with encouraging or discouraging certain activities, and still others simply reflecting the largesse accorded powerful interest groups that compete successfully for favors in the legislative arena.

Historically, the favorable tax treatment accorded credit unions was designed to encourage their formation as a means of providing credit to those who were neglected by commercial institutions. The effect has been to put credit unions at a competitive advantage vis-à-vis commercial institutions. However, there are limits to this beneficence: it extends to the institution and not to individual shareholders. Thus, credit union shareholder dividends are not treated like stock dividends in calculating personal income. To do so would tilt the competitive balance too far in favor of credit unions. Still, in examining the principles underlying the formation of credit unions, we are persuaded that a credit union shareholder is more like a stockholder of a corporation than a creditor. The dividends received, like the reduced loan rates and other financial services provided, represent a return to the shareholder of earnings from the pool of money formed by deposits of shareholders and profits thereon. The Board's denial of an interest deduction for that portion of the dividends traceable to third party investments was proper. The trial court did not err in so concluding.

D. Deductibility of Share Dividends as an Ordinary and Necessary Business Expense

As an adjunct to their argument on the deductibility of share dividends as interest, Taxpayers argue that share dividends are deductible as an ordinary and necessary business expense. The argument runs on for two sentences and is not accompanied by citation to authority. We consider it only insofar as it is embraced by Taxpayers' larger argument pertaining to the trial court's rejection of their proposed allocation formula.

III

As distinguished from investment clubs, mutual funds, and other associations created to pool funds for investment purposes, credit unions were developed to promote thrift and provide a source of credit for their members. Credit unions are authorized to invest their surplus funds. (Fin. Code, §§ 14404, 14650 et seq.) However, the amount and range of permissible investments has been limited consistent with the limited role of investments in credit union operations. Because loans have a higher yield, investments are permissible only when insufficient loan demand results in a surfeit of funds that would otherwise sit idle, generating no return. The amount of investment income, while modest in comparison to income from loans, is nonetheless significant. As noted earlier, credit unions are not tax exempt. However, income arising from transactions with or for members is exempt from taxation. (Rev. & Tax. Code, § 24405; *Woodland Production Credit, supra*, 225 Cal.App.2d at

pp. 299-300.) As we previously concluded, third party investment transactions are not considered "with or for members" and thus income from such transactions is taxable.

Because Taxpayers earn both exempt and nonexempt income, section 24425 comes into play. Section 24425 limits the amount of otherwise deductible expenses allocable to nontaxable income. No deduction is allowed for any "amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year." (§ 24425.) The trial court correctly concluded that section 24425 "prevents the reduction of the non-exempt income by expenses incurred in production of exempt income."

Taxpayers seek to deduct expenses associated with the production of taxable investment income. The trial court determined that the effort and expense required to generate such income is minimal. As exemplified by the experience of taxpayer Golden One, investment activity is sporadic and involves straightforward choices: investments consisted primarily of government securities, certificates of deposit, and accounts in Wescorp, a corporate credit union liquidity facility.[11] Golden

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[11] The trial court found that "at the administrative level plaintiffs and defendant agreed that the Golden One case was to be treated as the lead case to determine all common issues [and] that at the administrative level none of the plaintiffs other than Golden One identified any distinguishing factual or legal

One purchased a corporate bond in 1972 and government securities in 1970-1976.[12] It had a small ICU investment and a certificate of deposit in a bank. Consistent with the amount of investment activity, the number of personnel involved in the purchase of investments was small. Investment decisions were made by the asset/liability management committee, consisting of the chief financial officer, the chief executive officer, and four vice presidents. Their decisions were implemented by the accounting department under direction of the chief financial officer. Once implemented, the effort required to maintain investments was relatively small -- personnel were simply required to receive and record interest remittance notifications.

Taxpayers made no effort to calculate the actual cost of placing and selling taxable investments. They acknowledge that direct expenses, i.e., expenses related solely to the investment function, could not be ascertained for the periods in question. Instead, they proposed a three-step formula for calculating the portion of operational expenses attributable to the production of taxable income. The first step, after determining the total amount of expenses for credit union operations generally, involves the subtraction of all expenses related solely to the production of nontaxable income. The remainder consists of two

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issues other than minor issues which were resolved at the administrative level and are not part of this lawsuit."

[12] The Board sought to limit evidence of credit union activities to those pertaining to Golden One. However, while a great deal of evidence pertaining to Golden One came in, evidence of the operations of other credit unions was admitted as well.

categories of expenses: those related solely to the collection and maintenance of share deposits, and those related jointly to loans and shares. In step two, the share-related expenses are allocated between taxable and nontaxable income based on the ratio of the average total taxable assets to the average total assets.[13] Step three involves the allocation of joint lending and share expenses on a dollar-labor allocation scheme, using account balances. The goal is to ascertain the expense of maintaining the share accounts that funded taxable income. The percentage of operating expenses related solely to loans is calculated as the ratio of the total dollar amount of shares to the dollar amount of shares plus loans. The remaining percentage, which represents the percentage of expenses related to shares, is then multiplied by the ratio of taxable assets to total assets to determine the percentage of expenses that fund taxable investments.

The trial court rejected Taxpayers' formula. The court wrote: "The court further finds that the burden of proof is on plaintiffs to prove they are entitled to the deductions they have claimed. They have the obligation to maintain the books and records which relate to the transactions and to make them available to the taxing authorities which would substantiate plaintiffs' asserted allocation of expenses between the respective classes of income. Plaintiffs' records made

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[13] This is the same formula used to allocate financing costs, premised on the deductibility of dividends discussed earlier.

available to the defendants and their respective tax returns do not adequately evidence that their claimed deductions are not in any way referable to their exempt income. [¶] The court further finds that the identification and allocation of direct expenses is mandatory and that indirect allocation cannot be asserted as to directly allocable expenses."

The court continued: "[P]laintiffs are required to produce evidence that will satisfy the burden of proof that any claimed direct expenses is [*sic*] traceable to and would not have been incurred but for the activity which is directed toward the production of taxable income, and that any claimed indirect expense is a fixed expense or overhead and is not an expense which is traceable to and would not have been incurred but for the activities which are directed toward the provision of loans and services to members."

The parties cite no cases, and we have found none, describing a taxpayer's burden of proof under section 24425. Our review of the judgment disallowing the deductions is further complicated by the paucity of state tax law cases and the overabundance of federal statutes, regulations, and cases that are not without relevance to the issues before us but, indiscriminately applied, can serve as a source of confusion.[14]

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[14] Thus, for example, counsel for Taxpayers insisted at oral argument that the United States Supreme Court decision in *Hunt-Wesson, Inc. v. Franchise Tax Board of California* (2000) 528 U.S. 458 [145 L.Ed.2d 974] (*Hunt-Wesson*) completely undermines the trial court's reasoning on application of expenses. A unitary tax case, *Hunt-Wesson* involved the

We also have been hampered by a technical but imprecise lexicon, which shifts from case to case and often blends accounting with legal terminology. The same term may have multiple meanings.[15]

The difficulty is not in understanding section 24425, but in applying it to the muddled facts of this case. As exemplified by Golden One, Taxpayers have not conducted their investment activities in a manner that permits precise cost accounting. The personnel who placed and tracked investments engaged in multiple other tasks. No time sheets were maintained. The desks, telephones, and other office equipment employed by those personnel were used for a multitude of other purposes besides investments. Office space was not set aside

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deduction of interest expenses by a multistate corporation that also maintained discrete business enterprises generating nonunitary income that California could not otherwise tax. The court concluded that California's efforts to limit the deduction of interest expenses to amounts in excess of nonunitary dividend income violated the due process and commerce clauses. The issues in *Hunt-Wesson* are not the same as those involved in the present case. The court also was not concerned, as we are, with statutes and policies underlying the tax benefits afforded credit unions. The decision is neither controlling nor compelling in relationship to the issues raised by the current appeal.

[15] For example, the word "direct" is one of the worst culprits. In one opinion by the State Board of Equalization, "direct" was used in three different ways in one sentence, although the term was never defined: "In the absence of *direct* evidence linking indebtedness with a particular purchase, the IRS, and this Board, will determine whether the totality of the facts and circumstances establish a sufficiently *direct* relationship between the borrowing and the investment to allow for a *direct* allocation between those two items." (*Appeal of Zenith National Insurance Corp.* (Bd. of Equalization, Jan. 8, 1998) 1998 WL 15204, italics added.)

for and dedicated to investment operations, so it was not possible to precisely calculate the cost of overhead attributable to investment-related activities.[16] The failure of Taxpayers to maintain records separately delineating expenses related to nonexempt income from those incurred for exempt income is central to the trial court's ruling.

The trial court concluded that Taxpayers were obligated to prove "their claimed deductions are not in any way referable to their exempt income." The court drew a distinction between "direct" and "indirect" expenses, as well as between direct and indirect allocation of expenses. Indirect expenses are fixed expenses or overhead. By negative implication, all other expenses are "direct." To be deductible, according to the trial court, direct expenses must be traceable to activity directed

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[16] Further, the source of the funds used for investments, whether from share deposits directly or from loan income, is also uncertain. Taxpayers correctly discern that no loans or investments could be made without shareholder deposits, and deposits are unlikely without the lure of shareholder dividends. The same reservoir of funds used for member loans is used to purchase investment securities, and the return from both pays the dividends that attract deposits, thereby completing the cycle of financial transactions crucial to credit union operations. Because investments and loans are derived from a common reservoir of funds, Taxpayers insist that common expenses should be allocated pursuant to a formula that apportions expenses based on the relative value of assets producing the two categories of income. This simple approach of tracing funds from source to disposition and allocating expenses accordingly makes sense from an accounting standpoint. It is, however, only an abstraction; there is no evidence that actual investment expenses, the labor and materials expended on investment placing and tracking investments, bear any relationship to the expenses incurred in collecting and maintaining deposits.

toward the production of taxable income; the taxpayer must show the expense would not have been incurred but for the activity. On the other hand, indirect expenses must not be traceable to activities that are directed toward the provision of nontaxable income. The identification and allocation of "direct expenses" is mandatory, according to the trial court; "indirect allocation" will not suffice for "directly allocable" expenses.

The trial court's analysis, including the "but for" burden of proof, is drawn from the United States Tax Court decision in *Atlanta Athletic Club v. C.I.R.* (1991) 61 T.C.M. (CCH) 2011 (*Atlanta Athletic Club*). It was not, however, described as a burden of proof in the *Atlanta Athletic Club* case, but rather as a definition of direct expenses. "Direct expenses of an undertaking are those which increase in direct proportion to the volume of that undertaking. Each dollar of direct expense is traceable to a particular undertaking and would not have been incurred but for that undertaking." (*Id.* at p. 2013.) The court also defined indirect expenses: "Indirect expenses include overhead and fixed expenses. Fixed expenses, such as property taxes and depreciation, are incurred whether or not there is an undertaking." (*Ibid.*)

The Board urges us to accept the rationale of *Atlantic Athletic Club* and other cases involving exempt social clubs, including *Portland Golf Club v. Commissioner* (1990) 497 U.S. 154 [111 L.Ed.2d 126] (*Portland*), where the court characterized expenses as "direct" or "indirect" in discussing their deductibility. The Board argues that state-chartered credit

unions are analogous to social clubs in that their investment income is taxable whereas the investment income of charitable organizations is not. Moreover, the Board contends that the social club cases are the only cases in which direct and indirect expenses are expressly defined.

Federal tax laws can and should be used as analogies to help resolve state tax questions. (*Newman v. Franchise Tax Bd.* (1989) 208 Cal.App.3d 972, 979.) This case demonstrates the potential pitfalls, however, in importing fluid accounting terminology from one tax context into another. The term "direct" in the social club cases is a term of art related to the deductibility of expenses by social clubs under federal law that exempts social organizations from income taxation except as to "unrelated business taxable income." Unrelated business taxable income is defined as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are *directly connected* with the production of the gross income (excluding exempt function income) . . . ." (26 U.S.C. § 512(a)(3)(A), italics added.)[17] Consequently, the "directly" requirement in *Atlanta Athletic Club* and the "but for" discussion in *Portland* are based on statutory language that differs from the language involved in the present case. In any event, the classification of expenses as direct or indirect was irrelevant to the dispositive issues in the two cases because

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[17] Treasury Regulation section 1.512(a)-1 (26 C.F.R. § 1.512(a)-1).

the parties stipulated as to the amount of "directly related" expenses. Moreover, though investment income figured in the calculation of the clubs' tax liability, the deductibility of investment-related expenses was not raised. Rather, the taxpayers sought to offset losses from one taxable activity -- sales and services to nonmembers -- against gains from another activity -- passive investments.

We conclude, therefore, that rules articulated in the social club cases relied on by the Board and the trial courts do not resolve the issues before us. There remain the questions of what rules should apply and whether Taxpayers provided adequate support for the claimed deduction.

Though its reliance on social club cases was misplaced and its importation of nomenclature from those cases is without support, the trial court's basic approach to the review of Taxpayers' claimed deduction is reasonable. The trial court correctly recognized that deductions are a matter of legislative grace and the burden of clearly demonstrating the right to a claimed deduction falls on the taxpayer.[18] Here, the deduction claimed is for the ordinary and necessary expenses paid or incurred in carrying on a business. (§ 17201, subd. (a); 26 U.S.C. § 162.) Section 24425 limits the deduction; to the

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[18] "Deductions may be allowed or withheld by the Legislature as it sees fit [citations] and such deductions, like credits and exemptions, are to be narrowly construed against the taxpayer [citations]." (*Great Western Financial, supra*, 4 Cal.3d at p. 5.)

extent a claimed expense is "allocable" to nontaxable income, no deduction is allowed. Hence, the burden was on Taxpayers to substantiate the deductibility of any claimed expenses as solely attributable to the production of taxable income.

Because of section 24425, it is useful to describe the "business" of the credit union. Two categories of business are pertinent. Business activities for or with credit union members result in tax exempt income against which no deductions are permitted. All other business activities result in taxable income from which deductions are allowed. As discussed earlier, investment income falls into the latter category.

The trial court correctly discerned two categories of expenses related to the production of investment income: 1) expenses incurred exclusively for taxable investment functions, and 2) expenses for functions that support both taxable investments and nontaxable functions. Taxpayers produced no records and advanced no claim of any expenses that fall into the first category.[19] Therefore, this case is about the second category, dual use expenses. The deductibility of such expenses becomes problematic because section 24425 forbids the deduction of amounts allocable to exempt income.

Where expenses must necessarily be incurred to carry out activities for or with credit union members, it is no longer

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[19] It appears that in 1976 and 1977 Northrop Credit Union claimed deductions for salaries, dues, assessments, and audit expenses as well as overhead allocated on the basis of salary ratios.

necessary to incur such expenses for other business activities, including investment activities that result in the production of exempt income. To permit a deduction in such circumstances would be to allow "as a deduction [that] which is allocable to one or more classes of income not included in the measure of the tax imposed . . . ." (§ 24425.) Where expenses necessarily incurred to perform essential credit union functions are charged off to activities that are not "for or with" the members of the credit union, the government effectively pays part of the cost of expenses incurred in the production of tax exempt income. The trial court therefore was appropriately concerned about permitting a deduction of expenses for the production of investment income given evidence that virtually all of the credit union's expenses would have been incurred in the absence of any investment activity.

The core credit union functions are share deposits and loans. Only if the demand for loans is inadequate does the investment function come into play.[20] The typical operating expenses incurred by the credit unions in the share account deposit function include the cost of receiving the funds, accounting for deposits, keeping track of deposits, and providing for share withdrawals. Expenses incurred in the loan function typically are costs of interviewing, accepting or

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[20] Indeed, tax liability is largely eliminated if a credit union commits all of its funds to member loans, although this prospect would be unlikely over an extended period given ordinary fluctuations in loan demand.

rejecting loan applications, keeping track of loan balances, and collecting interest payments, as well as delinquency costs for bad loans. The expenses associated with the investment function involve the placement of investments and the tracking of investment returns. The functions and resources applied to their performance overlap. Because the investment function requires minimal personnel resources, the function is performed by personnel who are otherwise assigned to handle deposits or loans. The space and materiel required for investments are also shared with loans and deposits.

Taxpayers' allocation formula assumes the same relationship between expenses and the production of investment income that exists between expenses and the production of loan income. There is no evidence to support this assumption, while there is much evidence to dispute it. As the trial court noted, the investment function, as exemplified by Golden One's experience, required little time or personnel, while loans required a substantial application of personnel and other resources.

The Board also notes the dramatic disparity between investment income and loan income. Taxpayers note that in the case of Golden One, investment income constituted a meager 0.9 percent of total income, but under Taxpayers' proposed formula, 1.455 percent of "financing costs" and "capital maintenance costs" would be allocated to taxable investment income. This would result in a net loss. The only activities undertaken by Golden One with respect to investments consisted of the receipt of payments, deposit of funds, and the

maintain deposits and loans also support investments; expenses should be allocated accordingly.

The history of credit unions and the statutes regulating them belie this assumption. A financial institution without a loan function might serve a beneficial purpose, earn a reasonable return for its members, and might be authorized to conduct business (although the tax treatment would differ), but it could not be a credit union. It would not be "a cooperative, organized for the purposes of promoting thrift and savings among its members, creating a source of credit for them at rates of interest set by the board of directors . . . ." (Fin. Code, § 14002.) Without denigrating their importance as a tool in managing liquidity, investments have not been recognized as an essential credit union function. They do not constitute "business activities for or with" credit union members. They are ancillary to the essential credit union deposit and loan functions. In elevating the investment function to the same status as loans and deposits, Taxpayers' apportionment formula goes awry.

The deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" (26 U.S.C. § 162(a)) is intended to cover ordinary day-to-day costs of running a business, like salary and rent, to ensure that only a taxpayer's net income is taxed. The rationale is simple: a taxpayer who earns $20 in conducting an enterprise with no expenses should pay the same taxes as one who earns $300 but incurs $280 in expenses. (See *Helvering v.*

Independent L. Ins. Co. (1934) 292 U.S. 371 [78 L.Ed. 1311].) That purpose is not served by permitting a deduction for illusory expenses that are more the product of creative accounting theories than economic reality. True, not all tax principles reflect economic reality; the tax system often serves public policies disconnected from the realities of the marketplace. However, there is no indication the Legislature intended the business expense deduction to reflect anything but the actual cost of doing business. The real cost of selecting, placing, and tracking investments is far less than the amounts reflected in Taxpayers' apportionment formula.

This is not to suggest that Taxpayers are obliged to adopt a specific accounting system whereby each expense must be identified as incurred. It may be possible to devise an apportionment formula that accurately measures the expenses associated with the investment function. However, Taxpayers must bear the burden of proving the reasonableness of any methodology employed to allocate dual expenses to taxable and nontaxable income. No particular methodology or accounting system is required as a matter of law. Nonetheless, the trial court could plausibly conclude, as it did, that Taxpayers' proposed allocation formula overstated the amount of expenses associated with investments and therefore could deny the claimed deduction for lack of factual support.[21] Thus, while the trial

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[21] We note Taxpayers' reliance on Internal Revenue Code section 265(b)(2) as support for its allocation formula. We

court relied on inapt authority for its decision, it did not err in denying the claimed deduction.

IV

Taxpayers contended in the trial court, as they reiterate on appeal, that Audit Ruling 111.1 is a void underground regulation and assert that the trial court, while declining to determine the audit ruling's validity, nonetheless gave deference to it. The trial court declared it was unnecessary to decide whether the regulation offended the Administrative Procedures Act (APA) (Gov. Code, § 11340 et seq.). Nevertheless, it expressly relied on *Appeal of Southern California Central Credit Union* (Bd. of Equalization, Feb. 3, 1965) 1965 WL 1344 (*Central Credit Union*), which itself was predicated on Audit Ruling 112.2, the predecessor to Audit Ruling 111.1, which allowed credit unions a deduction for all expenses directly attributable to taxable income plus a deduction of the greater of 1 percent of the investment income or $100 for indirect expenses. In *Central Credit Union*, the State Board of Equalization upheld the practice, explaining: "Appellant's entire argument rests upon the premise that its indirect expenses should be allocated to income in the proportion that the assets producing that income bore to total

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agree with Taxpayers that California's failure to expressly adopt federal statutory provisions does not destroy their value as analogous authority. However, federal rules on the allocation of interest expenses between taxable and nontaxable interest do not provide a fitting analogy for the allocation of expenses between loan and investment income.

assets. Aside from testimony to the effect that this is a standard accounting practice, the record is bare of any factual support for this method. . . . [¶] Appellant's formula itself is arbitrary and there is no evidence to show that the $100 allowance by respondent is inadequate. In view of the nature of the investments involved here, the relatively few accounts they entailed and the minimal number and complexity of the transactions which they required, we find nothing which would compel us to reverse or adjust the Franchise Tax Board's determination."

In light of the trial court's express disavowal of Audit Ruling 111.1 as a basis for its decision, the legal issue presented concerns the court's reliance on *Central Credit Union*. "While an interpretation put forth by an administrative agency charged with enforcement, implementation and interpretation of enactments is entitled to great weight [citation], a court may properly accept or reject it according to the validity of its reasoning, its consistency, 'and all those factors which give it power to persuade, if lacking power to control.'" (*Rain Bird, supra*, 229 Cal.App.3d at p. 792.) Regulations issued without compliance with the APA are void; the tax agency may not enforce them and the courts may not give them any weight or deference. (Gov. Code, § 11347.5; *Goleta Valley Community Hospital v. Department of Health Services* (1983) 149 Cal.App.3d 1124, 1129.)

Taxpayers make a credible argument that the audit ruling is void as an underground regulation. The trial court erred by relying on *Central Credit Union* without deciding whether the

audit ruling violates the APA. We are not persuaded, however, that the trial court's reliance affected the outcome of appellant's refund action. Neither Audit Ruling 111.1 nor *Central Credit Union* are essential to the Board's position. Any error is harmless.

V

After Taxpayers filed tax returns claiming the deductions that are the subject of the present appeal, the Board issued notices of proposed assessment denying the deductions. Taxpayers filed protests of the notices, and thereafter an extended exchange of correspondence and conversations ensued between the hearing officers assigned to hear the protests and Taxpayers' counsel. Hearings were conducted and decisions denying the separately filed protests were rendered.

Taxpayers complain that the notices of proposed assessment sent to Taxpayers stated that the Board was acting on the basis of Audit Ruling 111.1, but the ultimate decision was based on a different reason, the "but for" test sustained by the trial court. Taxpayers argue that due process requires disclosure of an administrative agency's working rules. By not disclosing their application of the "but for" test, the Board deprived Taxpayers of an opportunity to address the actual basis for the assessment. Taxpayers also assert the Board's proceedings were unfair because the absence of accepted procedures or standards of proof deprived them of the opportunity to prove their entitlement to the deductions given. Finally, Taxpayers maintain the Board's hearing officers were not impartial

decision makers: the officer assigned to the Golden One protest, Lorrie Inagaki, served simultaneously as advisor and advocate for the Board; and James York, who handled the other protests, considered the potential revenue loss to the state were Taxpayers to prevail and thereby displayed a bias in favor of the Board's position.

Principles of procedural due process under the Fourteenth Amendment of the United States Constitution require that before being deprived of property, a person must be afforded a hearing before a judicial or quasi-judicial body in accordance with established legal rules. (*United States v. James Daniel Good Real Property* (1993) 510 U.S. 43 [126 L.Ed.2d 490].) The precise nature of the procedures due process requires depends on the nature of the government function involved and the private interests at stake. (*Goldberg v. Kelly* (1970) 397 U.S. 254, 263 [25 L.Ed.2d 287, 296].)

We recognize that principles of procedural due process apply in some instances to administrative tax determinations. The Board characterizes the proceedings in the present case as "pre-assessment non-adjudicatory tax proceedings" and insists the due process requirements applicable to adjudicatory proceedings do not apply. Moreover, according to the Board, "[i]n tax proceedings due process is met if the taxpayer is given an opportunity for hearing in a suit for collection or in a suit for refund after payment. (*People* v. *Santa Fe Ry. Federal Savings and Loan Association* (1946) 28 Cal.2d 675, 681.)"

The Board is correct. Due process does not compel a hearing prior to the assessment of tax liability. It is well established that postdeprivation procedures will satisfy the demands of due process (*Reich v. Collins* (1994) 513 U.S. 106 [130 L.Ed.2d 454, 459] (*Reich*); *Morris Plan Co. v. State of California* (1946) 73 Cal.App.2d 415, 420-421 (*Morris Plan*)), although where the state chooses to provide predeprivation procedures, principles of due process will apply to those procedures (*Reich*, at pp. 110-111; *Morris Plan*, at pp. 420-421). Taxpayers argue that the Legislature has provided for preassessment notice of tax liability and an opportunity to be heard, and this statutorily granted hearing is adjudicative in nature and must accord Taxpayers certain minimal protections of due process.

Under the procedures in effect at all pertinent times involved in this appeal, after a tax return is filed, the Board examines it and determines the correct amount of the tax. (§ 19032; formerly § 25661.) If the taxpayer's calculation of the tax owed is less than the tax determined by the Board, the Board mails to the taxpayer a notice of proposed deficiency assessment. (§ 19033; formerly § 25662.) The notice sets forth the reasons for the proposed deficiency assessment and the computation thereof, and the last day on which the taxpayer may file a written protest. (§ 19034; formerly § 25662.) The taxpayer may then file a protest. (§ 19041; formerly § 25664.) If a protest is filed, the Board must reconsider the assessment of the deficiency and, at the taxpayer's request, grant an oral

hearing. (§ 19044; formerly § 25666.) The Board acts upon the protest; assuming no appeal, the Board's action is final 30 days after it mails the notice of action to the taxpayer. (§ 19045; formerly § 25666.) Assuming an adverse outcome, the taxpayer has a right of appeal to the Board of Equalization (§ 19045; formerly § 25666) or may pay the tax and thereafter commence an action for refund. If the taxpayer chooses to pay the tax after the protest is filed but before the Board acts on the protest or the Board of Equalization acts upon an appeal from the Board's action, the protest or appeal is thereafter treated as a claim for refund.[22] (§ 19335; formerly § 26078.) Due process is thus afforded by a combination of preassessment administrative review and postassessment judicial review.

The Board asserts, and the record appears to support the notion, that Taxpayers acted pursuant to a coordinated legal strategy aimed toward judicial review of the claimed deductions. Legal counsel representing Taxpayers conferred with the Board on the scheduling of administrative proceedings and the selection of a case presenting the best factual situation to litigate in court. Ultimately, Taxpayers paid the taxes assessed and filed refund claims. Litigation before the superior court followed in

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[22] Taxpayers' protests were all converted to claims for refund in this manner. While Taxpayers no longer had a right to hearing before the Board, they insist their due process claims remain viable in light of the Board's historic practice of affording hearings and processing protests to conclusion even after protests are converted to refund claims.

due course. The Board was simply a way station en route to judicial review.

Accepting Taxpayers' assertion that the adequacy of due process must be measured by the procedures utilized by the Board rather than the later judicial proceedings, Taxpayers were afforded all the due process to which they were entitled.

Taxpayers complain the notice of proposed tax assessment was inadequate because it did not inform Taxpayers of the "but for" rule and the Board's interpretations of Audit Ruling 111.1, or the definitions of direct and indirect expenses that figured in later judicial proceedings. Such specificity was not required. Both sides understood that the deductions claimed by Taxpayers raised issues of first impression that would be the subject of protracted litigation. Legal counsel for Taxpayers engaged in extended oral and written exchanges with Board personnel during the course of the administrative proceedings, in which each side explained and defended its respective position. The Board was not compelled to outline in its notice of proposed tax assessment the arguments it would later assert in the trial court and on appeal. There is no indication that Taxpayers were at all handicapped in asserting their legal claims by the inadequacy of the Board's notice.

Taxpayers also argue the Board's hearing officers acted in dual roles and thereby violated the due process requirement that decision makers be impartial. Hearing Officer Inagaki, they assert, acted as advisor to and advocate for the Board as well as the hearing officer in the Golden One protest. Hearing

Officer York, we are told, was instructed *not* to calculate the potential revenue loss to the state were Taxpayers to prevail on their protest but calculated the potential loss nonetheless, thereby demonstrating his lack of impartiality. It is not clear that due process compels the Board to confine its hearing officers to purely decision-making functions and to isolate them entirely from advice and advocacy roles.[23] In any event, Taxpayers' claim of bias is not supported by the record. Taxpayers do not support their claim that Ms. Inagaki acted simultaneously as advisor and advocate for the Board while serving as hearing officer in the Golden One protest with citation to supporting evidence. The fact that Mr. York may have developed information on the fiscal consequences of Taxpayers' claims does not establish bias in the consideration of the claims. Moreover, Taxpayers cannot demonstrate prejudice from the actions of Inagaki and York in light of the facts that the protests were converted to claims for refund and decision-making authority was removed to the courts. Inagaki and York were not involved in the consideration of Taxpayers' judicial

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[23] *Nissan Motor Corp. v. New Motor Vehicle Bd.* (1984) 153 Cal.App.3d 109, cited by Taxpayers, involved the composition of the New Motor Vehicle Board. The nine-member board, which included four new car dealers, determined a motor vehicle manufacturer had terminated a dealer franchise without good cause. The Court of Appeal concluded the disparate representation of new car dealers on the board at a minimum created an appearance of bias and denied vehicle manufacturers a fair hearing. The case is not helpful in resolving Taxpayers' argument in the present case.

claims. Whatever actions they might have taken did not influence the later course of the present case.

VI

By cross-appeal, the Board contends the trial court erred by granting Taxpayers' motion in limine to prevent it from raising the issue of taxability of income from investments in corporate credit unions (the "WesCorp issue").[24] Taxpayers argued the Board should be precluded from raising the issue since it had not been affirmatively pled in the answer or litigated in the administrative proceedings. We agree.

We must begin with some basic law on refund actions. Since a suit to recover a tax refund is an action in equity, "a taxpayer is not entitled to a refund unless it has, in fact, overpaid its taxes." (*Sprint Communications Co. v. State Bd. of Equalization* (1995) 40 Cal.App.4th 1254, 1260 (*Sprint Communications*).) "'[A] refund case throws open the taxpayer's entire tax liability for the period in question . . . , and the Board may raise issues unrelated to the basis or theory on which the taxpayer is seeking a refund in order to defeat the claim.' . . . In other words, while a taxpayer's refund claim might be proper, there might be other items which the taxpayer omitted from its return for that year, which if included would show that the taxpayer had underpaid its tax. (*Pope Estate Co.* v. *Johnson*

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[24] The so-called "WesCorp issue" concerns the taxability of income received by Taxpayers in transactions with Western Corporate Credit Union, which operates as a credit union for credit unions.

(1941) 43 Cal.App.2d 170, 173 [110 P.2d 481] (*Pope Estate*).)" (*Sprint Communications, supra*, 40 Cal.App.4th at p. 1260, italics omitted.) Consequently, in *Sprint Communications*, "the Board was compelled to raise all claims concerning unpaid use taxes for the timeframe encompassed in the refund claim period which might be set off against Sprint's refund claim, or forego the right to collect any taxes for that period." (*Ibid.*)

There is no question the Board was entitled to raise the WesCorp issue as a setoff to any refund in the administrative proceedings. The issue, however, is whether it could be raised for the first time in the ensuing refund action in the superior court and, if so, whether the Board's answer sufficiently raised the issue. We conclude the trial court properly precluded the Board from litigating the setoff claim under *Title Ins. Co. v. State Bd. of Equalization* (1992) 4 Cal.4th 715, 729-733 (*Title Ins.*).[25]

In *Title Ins.*, the Supreme Court rejected the Board's position. The Court wrote: "The insurers assert that the superior court lacked jurisdiction to rule on the premiums issue since the Board failed to raise this issue in the administrative proceedings. While it is evident that the taxpayer is limited to those claims pursued in the administrative proceedings (see Rev. & Tax. Code, §§ 13102-13104), the issue of whether similar

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[25] Taxpayers contend section 19802, subdivision (b) bars the Board from raising the WesCorp issue as a setoff in the refund action. Since we conclude *Title Ins.* is dispositive, we do not reach this contention.

limits apply to the Board has not been previously addressed. The Board must follow certain administrative procedures when charging the taxpayer with deficiencies. These procedures are delineated in Revenue and Taxation Code sections 12421 through 12435. . . . [¶] By claiming that the title insurers should not receive a refund because they should have paid taxes on the total premiums paid by their insureds to the title companies, the Board is essentially assessing a deficiency against the title insurers. However, the Board is charging such a deficiency without following the above mentioned statutorily required administrative procedures. Just as the taxpayer is limited to the claims it may assert in the superior court to those pursued in the administrative proceedings, the Board should be limited in its assertion of setoffs in the superior court action to those deficiency assessments formally pursued under Revenue and Taxation Code sections 12421 through 12435: '"Men must turn square corners when they deal with the Government," it is hard to see why the government should not be held to a like standard of rectangular rectitude when dealing with its citizens.' [Citation.]" (*Title Ins., supra*, 4 Cal.4th at pp. 729-730.)

Hence, the court found the setoff issues were not properly before the superior court because the deficiency assessments were not based on the setoff claim. The court rejected the setoff on an alternative basis as well, finding the Board had failed to affirmatively plead a setoff in the answer in the superior court action. The Board insisted a general denial was

sufficient. The Supreme Court disagreed, stating: "To accept the Board's position would place an unacceptable burden on taxpayers seeking refunds. As the Board notes, a refund case throws open the taxpayer's entire tax liability for the period in question [citation], and the Board may raise issues unrelated to the basis or theory on which the taxpayer is seeking a refund in order to defeat the claim. [Citation.] If the Board is not required to plead its defenses to refund claims, taxpayers would be forced to prepare for trial and conduct discovery in ignorance of any possible setoffs or defenses the state might assert. Taxpayers cannot prepare for unknown attacks on their refund claims. The burden would be particularly severe in a case such as this, in which the Board is seeking a setoff based on the taxability of the full premium, which it had never treated as income in the past, and which the insurers could not have expected to be at issue in the case." (*Title Ins., supra*, 4 Cal.4th at p. 732.)

Referring to the Supreme Court holding in *Title Ins.*, the First District Court of Appeal aptly wrote: "[T]he Supreme Court made it clear that it takes an equally dim view of attempts by the state to avoid strict compliance with the administrative machinery established by statute to consider refund claims." (*Farrar v. Franchise Tax Bd.* (1993) 15 Cal.App.4th 10, 21, fn. 9 (*Farrar*).) That is precisely what the Board is attempting to do here.

Having failed to seek a deficiency or raise the claim to a setoff in the administrative proceedings, the Board sought to

raise the issue for the first time in the refund action by way of general denials to Taxpayers' allegations. Under *Title Ins.*, a setoff claim raised in this fashion is not properly before the superior court.

The Board argues that *Title Ins.* compels the convergence of three factors, all of which are not present here. The Board misreads the Supreme Court holding. While the majority responded to each of the three arguments raised by the Board in *Title Ins.*, there is nothing in the opinion to suggest that the superior court can consider a new setoff claim unless all three of the facts present in that case (failure to follow deficiency procedures, failure to affirmatively plead a setoff, and stipulated facts) exist. A fair reading of the opinion suggests just the opposite. The court, as paraphrased by the First Appellate District in *Farrar*, expressed a very dim view of the Board's attempts to avoid strict compliance with the administrative machinery available to it. (*Farrar, supra*, 15 Cal.App.4th at p. 21, fn. 9.) We conclude the trial court properly excluded the setoff claim under compulsion of *Title Ins.*

Nor are we persuaded by the Board's assertion that the opinion should be denied retroactive application. We agree with Taxpayers that it is a long-standing maxim of California jurisprudence that a decision of a court of supreme jurisdiction is retroactive. (*Newman v. Emerson Radio Corp.* (1989) 48 Cal.3d 973, 978-981 (*Newman*); *Peterson v. Superior Court* (1982) 31 Cal.3d 147, 151-154.) Prospective application may be allowed

as an exception to the general rule of retroactivity only "when considerations of fairness and public policy are so compelling in a particular case that, on balance, they outweigh the considerations that underlie the basic rule. A court may decline to follow the standard rule when retroactive application of a decision would raise substantial concerns about the effects of the new rule on the general administration of justice, or would unfairly undermine the reasonable reliance of parties on the previously existing state of the law. In other words, courts have looked to the 'hardships' imposed on parties by full retroactivity, permitting an exception only when the circumstances of a case draw it apart from the usual run of cases." (*Newman*, *supra*, 48 Cal.3d at p. 983.)

The Supreme Court did speak to the issue of fairness in *Title Ins.* when it admonished: "To accept the Board's position would place an unacceptable burden on taxpayers seeking refunds." (*Title Ins.*, *supra*, 4 Cal.4th at p. 732.) As far as we can determine, the Board will not suffer a unique hardship unjustified by the equities of the case. It had ample opportunity to litigate the setoff issue in the administrative proceedings. It chose not to raise the issue during the appeal process or to clearly assert a setoff as an affirmative defense and thereby alert Taxpayers to the pendency of the claim. Hence, no discovery was conducted on the issue and WesCorp was not a party to the litigation. We reject the Board's invitation to review the squabbling between the parties during the protracted period in which Taxpayers worked with the Board to

reach resolution of the case. So far as we can tell, both sides vigorously pursued their respective positions in a complicated arena. We are unwilling to attribute sinister motives to either party or to consider their litigation strategies as a component of the equities to be considered when applying the case retroactively. Quite simply, there are no facts properly before us to justify limited application of dispositive Supreme Court authority.

DISPOSITION

The judgment is affirmed.

RAYE, J.

We concur:

NICHOLSON, Acting P.J.

MORRISON, J.